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RETAIL IPOs: BACK FOR ANOTHER ROUND

Richard Thalheimer, President, The Sharper Image

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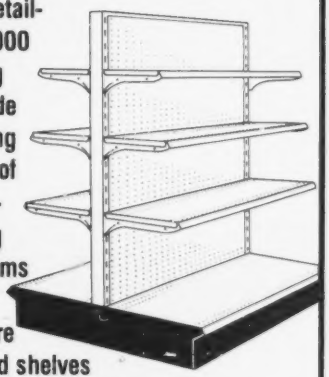

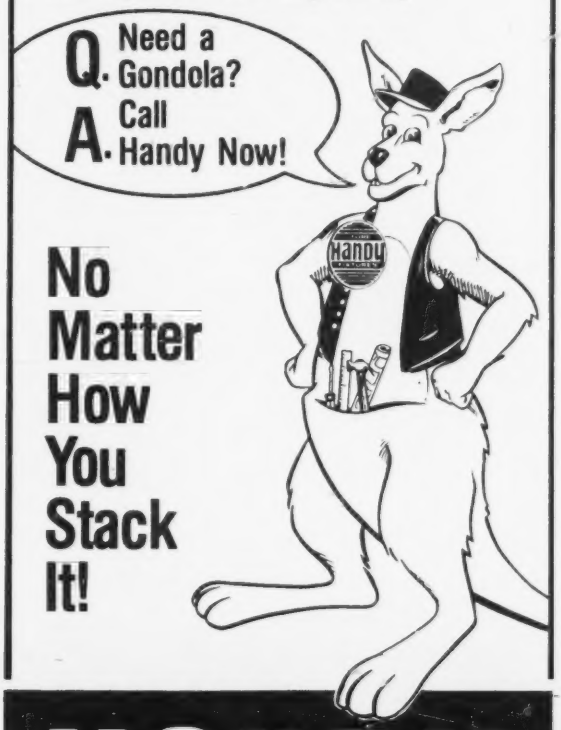

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RETAIL IPOs REBOUND AFTER MARKET CRASH

AFTER SIX-MONTH DROUGHT, MARKET FOR FIRST-TIME PUBLIC ISSUES RETURNS

Richard Thalheimer hired a limousine for the day of Oct. 19, 1987. The Sharper Image president and ceo had decided the afternoon would be a good time for touring New Jersey to look for new store locations for his San Francisco-based retail and catalog company.

In between potential store-site stops, Thalheimer figured he and the executives with him would plan for the stock analyst presentation they expected to do in Boston the next day.

News heard over the radio interrupted those plans. As the afternoon wore on, the Dow Jones Industrial Average plummeted, taking its biggest single-day drop in history. Black Monday was upon them.

When the dust settled, the value of The Sharper Image had dropped from the $82 million the stock market had placed on the company when its initial public offering (IPO) was made in April 1987, to only $45 million.

"It was a blow to the ego," Thalheimer admits.

Yet at the end of Black Monday, Thalheimer still considered himself a lucky man. In the spring, the entrepreneurial chief executive had taken his company public against the advice of at least one well-respected investment banking firm. The banker had suggested that October would be a more advantageous time for a new stock issue.

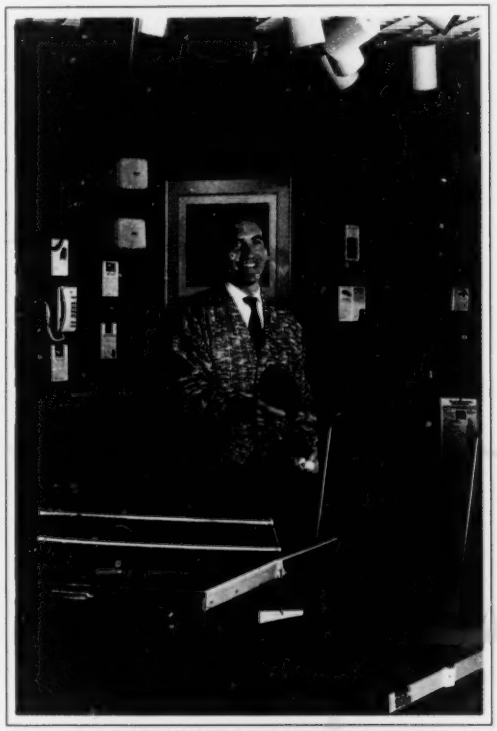
Thalheimer did not take that advice and instead went ahead with a $10 million offering in April.

"It turns out that it was a very lucky decision," Thalheimer says. "We probably could not have done it in the fall," he says.

Neither could any other company. In September 1987, a month before the stock market crash, there had been 62 initial public offerings, according to the *IPO Reporter*. In November 1987, the month after the crash, there were only six IPOs—none of them retail companies.

The dry spell for retail IPOs turned into a drought. For the first six months after the stock market crash, there was not a single retail issue brought to market.

According to Kidder, Peabody research, there were only four major capitalized retail IOs in the first half of 1988. At least two more were actively pending. This compares to 25 major retail IPOs for the full year of 1986 and 15 IPOs in all of ill-fated 1987.



THALHEIMER: IPO 'A MORE ATTRACTIVE ALTERNATIVE'

Retail public offerings, however, could be set for a comeback. In the last four months, the overall IPO market has picked up, lending strength to potential retail offerings as well.

In May, there were a total of 23 new issues, according to the *IPO Reporter*. In June, there were 26, in July there were 31. Among those offerings were the year's first successful retail IPOs, including Egghead Software (a computer software retailer), Babbages (another computer software chain), Casual Male (men's apparel) and Office Depot (an office supply superstore).

Also, Drug Emporium, a deep discount drug chain, recently began a public offering. ComputerLand, however, has delayed its IPO, citing adverse market conditions.

Other retail IPOs are in the wings. Alex. Brown & Sons analyst Fred Wintzer says that the Baltimore investment firm is advising a number of retail companies that are on the brink of public offerings.

"There is a huge backlog of retailers that want to go public," the analyst says.

Among them, says Wintzer, are five or six small, women's apparel chains. In addition, there are some big companies looking for the right opportunity to go public after leveraged buyouts.

"The major reason they're coming now is that the retail stocks have picked up meaningfully," Wintzer explains.

"Multiples have come up, stocks are up 25% or more from where they bottomed, and a number of companies find that the multiples are sufficient to justify going public," he says.

Price/earnings multiples for discount, department and fashion retailers through the second quarter are averaging 15. Food retailing stock P/E ratios at the end of the first half are averaging a hefty 17.

"What it's going to take to get more IPOs is a good environment for retail stocks in the general market," says Wintzer.

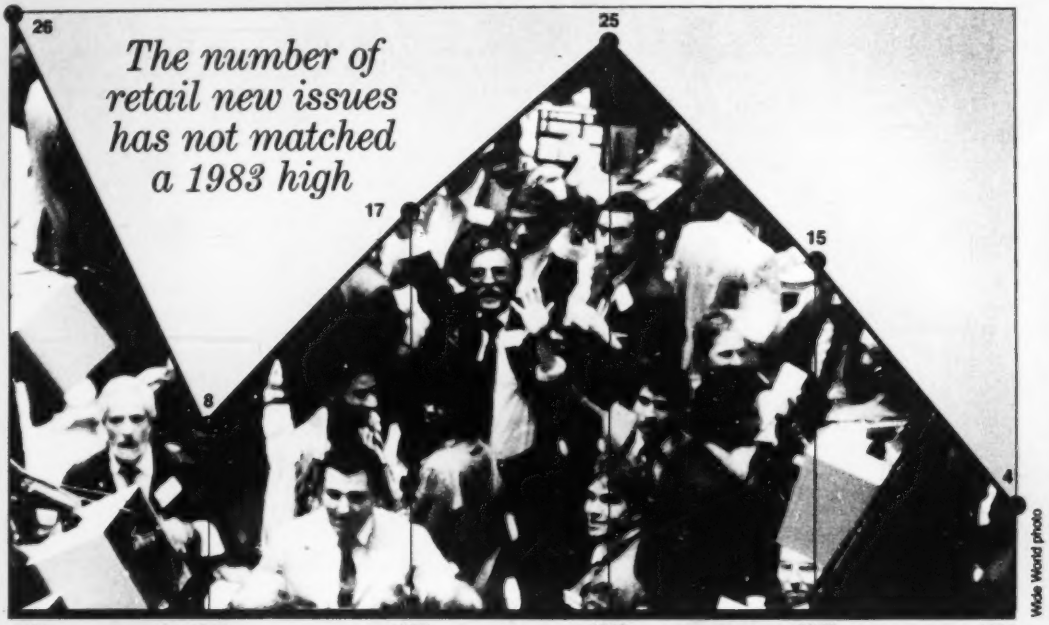
The health of that environment, the analyst thinks, will depend in great part on what happens in women's apparel retailing in the second half of this year.

If women's apparel comes out of its year-long slump, Wintzer says, then the outlook for all retail stocks—including new issues—will improve.

It is unlikely, however, that any emerging market for retail IPOs will match the headstrong days of the last five years. In addition, the number and quality of retail issues will differ significantly from the recent past, agree most observers.

"Last summer, almost anybody

RETAIL IPOs 1983-88



Source: Kidder, Peabody

and his brother could go public," says *IPO Reporter* executive editor Evan Guillemin.

Of the 15 major capitalized retail IPOs last year, according to Kidder, Peabody, most were companies returning from leveraged buyouts.

"Now it's definitely more selective. You have to have some kind of history and a good quality company," explains Guillemin.

"It's do-able now. The right companies can go public now," agrees Wintzer. "However, they've got to be top quality and high growth," he says.

Not everyone agrees. Kidder, Peabody retail trade research director Dan Barry thinks that the market for retail stocks and new issues will never go back to the "frothy days" of the last five years. In fact, Barry thinks the environment for retail stocks in general is set to weaken.

"We have a reversal of all the trends that positively affected the market for retail stocks in general—and retail IPOs in particular—five years ago," Barry says.

The analyst cites a still-weak dollar in international markets and upticks in both inflation and interest rates as negative factors affecting the market for retail stocks.

"We're predicting a recession," Barry says.

If retail companies cannot use public offerings to raise cash, where will they go? Though some predict that retailers will turn to commercial bankers, the answer is not always that easy.

For example, when Thalheimer was looking for cash to open new Sharper Image stores, he never seriously considered an alternative to a public offering.

"I guess we had different ways to finance it," Thalheimer says, "but going public was a more attractive alternative."

Besides, Thalheimer did not see going to commercial bankers to raise cash as a viable alternative.

"I've never found commercial bankers to be very receptive to entrepreneurial businesses. I'm sure there are some someplace who are, but I haven't seen them," he says.

Venture capital did not prove an alternative for The Sharper Image, either. Thalheimer says that venture capitalists did not value the company as high as its public offering ultimately did. Thalheimer expects that other companies looking to raise large amounts of cash will discover the same problem in searching out venture capital.

Had The Sharper Image not taken the public offering route, it is unlikely that it could have started on its current plan to open 200 stores nationwide. Even in the uncertain current environment, Thalheimer lists a second stock offering as the best route for his company to raise additional funds if it needed to.

If many retailers get cut off from easy sources of cash available through public offerings, say some industry watchers, the mammoth expansion in the number of new retail companies and new store sites that characterized the 1980s could grind to a halt in the 1990s. (Others are quick to point out, however, that in many cases venture capital funds may still fill the void).

In addition, a reduced market for retail issues could mean that companies that underwent leveraged buyouts will have trouble returning to the public market.

"Our intention always was to return to the public market," says Hills Department Stores chairman Ste-

phen A. Goldberger. Hills made a public offering July 1987. Had Goldberger waited another three months, however, Hills would not have been able to follow that strategy.

If the IPO environment does not change, R.H. Macy could face that same problem. Before its bid for Federated Department Stores and subsequent acquisition of I. Magnin and Bullock's, many had predicted that Macy would look to re-enter the public market in 1989.

Though Macy management remains mum, it now is unlikely that the company will seek to return to the public market that quickly.

Among Macy's biggest obstacles are the additional debt it incurred to get the former Federated divisions and the resulting losses it is posting this year. It is equally unlikely, however, that the New York-based department store company will seek to stay private for the long term.

Nor is Macy the only company affected. Both Safeway, the food retailer, and Eckerd Drug are additional candidates for return from leveraged buyouts back into the public arena.

The question is: What kind of market will the companies face if they decide to go public again?

Whatever the short term outlook for retail new issues, the consensus is that those like Macy that are both willing and able to wait, the market will come back—eventually.

"It will happen," says Alex. Brown analyst Wintzer. "Ours is a feast or famine business." ■

—Rick Gallagher

RETAIL IPOs: HOW THEY'VE FARED

Ask Richard Thalheimer why The Sharper Image went public in 1987, and the answer the president and ceo of the San Francisco retail and catalog chain gives is simple enough: "We needed the money."

The Sharper Image needed the $10 million it raised from its IPO to expand the number of retail stores the catalog company operates. (On the average, the chain spends between $300,000 and $500,000 to open a new unit.)

Since its IPO in April 1987, The Sharper Image has added 21 locations, growing from 28 last year to 49 a year after its first stock issue.

Ultimately, Thalheimer plans to operate up to 200 stores nationwide. If necessary, he says he will return to the public market to raise the cash to open them.

Nor is The Sharper Image alone. Most retail companies that entered the public arena last year used the cash they raised to open more stores.

Chestnut Hill, Mass.-headquartered Designs, a specialty retailer of Levi Strauss apparel that also went public in 1987, added 17 stores last year and will add another 16-20 stores in the current fiscal year, bringing its total to more than 60.

Canton, Mass.-based Hills Department Stores, meanwhile, went public in July 1987 after a leveraged buyout two years earlier. In 1987 the discount store chain added 17 stores. This year, Hills will add another 16.

Even with all the store building, the IPOs continue to outperform industry averages. The Sharper Image's earnings growth since 1982 is averaging 250% annually. Hills' five-year profit rate stands at over 11% annually. Designs' profits grew by almost half last year.

Retail IPOs as a group, however, seem a less than fetching investment for their shareholders. Though the 91 retail IPOs issued since 1983 have outperformed the Value Line Index (up 38% in five years for the retail IPO stocks, compared to 31% for the Value Line Index), the retail companies posted bigger losses than the market as a whole in 1987.

That might change. This year, the 91 retail IPOs once again are outperforming the broader market.

PRIVATE LABEL CREDIT: CAN INCENTIVES HELP?

CALIFORNIA STUDY SHOWS MORE USE OF BANK CARDS THAN STORE CARDS

The role of the private label card has changed, says Greg Bjorndahl, partner in The West Coast Group, an Irvine, Calif.-based strategic marketing firm, which helps companies build upon the equities in their products and organizations.

According to a recently completed study on credit card use in California, traditional department stores "must rethink their store cards" to encourage customers to sign up, carry, and use them. Bjorndahl believes many of the California study's results—dealing with types of card ownership, wallet penetration, card visibility, interchangeability and selection and use of various cards—apply nationwide.

PLASTIC MONEY: AVERAGE CONSUMERS CARRY 6 CARDS

"The department store card is the least carried in the wallet," he says, suggesting that its traditional function of "baiting impulse purchases is going away."

In rethinking the store card, perhaps retailers should consider offering incentives packages as general (bank) cards do, observes Bjorndahl, a former senior vp at Security Pacific Bank in Los Angeles.

Historically, store cards have not offered incentives, but Bjorndahl sees them as a "tremendous opportunity" for retailers who provide private label cards.

The time to seize this opportunity may be particularly ripe. Despite recent trends to consolidate overall debt, California credit card users are looking to get even more cards, according to the study.

While California consumers already carry an average of six credit cards, they express a desire to carry still one more piece of plastic.

In addition, the financial service and retail industry should be aware that California consumers are acquiring new credit cards, compared to consolidating them, at a 4 to 1 ratio, observes Bjorndahl.

Furthermore, the study says that 10% of the respondents are canceling cards, while another 10% anticipate doing so. But consumers are replacing canceled cards with another, depending on the consumer niche (attributes of a cardholder).

One type of card most substituted is the department store card, despite the study's claim that it is the least carried in the wallet. Bjorndahl attributes this inconsistency to this "business of niches."

The study also reveals that one in four people surveyed have more than one wallet for their cards, while one third say they keep their cards in locations other than their wallets.

So in examining the types of incentives to offer which will encourage consumers to carry a particular card in their wallets in an effort to obtain a greater share of the growing "plastic money" market, he suggests credit card vendors and retailers pay close attention to the niches of people in the process of card acquisition and consolidation.

The West Coast Group study "found definite niches for the department store category," says Bjorndahl.

"The attributes of a Sears cardholder differ from those of a J. C. Penney or Saks or any other major player," he notes.

Moreover, a store's private label card must compete with other store cards on a different level than Visa and MasterCard compete because the bank cards are general purpose ones, while the private label cards offer only

B. ALTMAN BOASTS CO-OP PROGRAM WITH AMERICAN EXPRESS

California retailers are not alone in rethinking the relationship between bank credit cards and private label store cards. According to Jack Schultz, president and ceo of New York-based B. Altman, if the store substantially increases its business with a bank card, he can accept not gaining any business with the store's private label card.

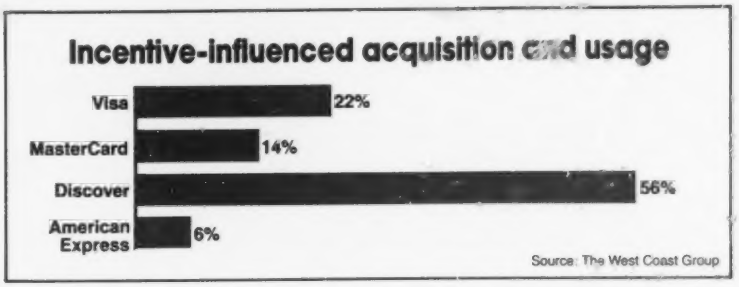
"What difference does it make?" he asks. "I'll spend 1% of sales any day to increase my [American Express charge] business 24%," says Schultz, pointing to the card's increased charge volume at B. Altman during 1987's holiday season, over the previous year's season.

The sales gain was especially sweet because it came at a time when retail analysts expected consumers to be cautious due to the October collapse of the stock market.

But the New York retailer knew that it could broaden the store's existing customer base beyond its house card clientele by developing a marketing program together with American Express, explains a spokesman for the card.

The program encompassed point-of-sale materials and television and newspaper advertising, which reminded customers that the American Express card is welcomed by the store.

The success of American Express' cooperative concept, says Greg Bjorndahl, partner in The West Coast Group, an Irvine, Calif.-based strategic marketing firm, caused Visa and MasterCard to follow on its competitor's heels with similar cooperative advertising strategies in an effort to sign up the 100 top department stores.



a specific place to shop, according to Bjorndahl.

Nevertheless, he believes retailers structuring private label card programs can learn something from bank card programs.

"We see national and incentive card acquisitions as a major trend in the credit card industry, both at state and national levels. The results of our research show that California consumers are predominantly acquiring cards from out of state institutions [banks], especially from those who offer incentive packages, such as airline mileage, cash rebates or specialized services," he says.

The study states 53% of the respondents own Visa cards, and 25% of Visa's market share was influenced by the incentive package. Fifteen percent of the total 32% market share for MasterCard was influenced by incentives, while 48% of the Discover card's 13% market share was influenced by the card's unique cash rebate program.

The results of the study also indicate that Visa cards are three times more likely to have been recently acquired over MasterCard, and those cards are not being issued from local banks.

According to Terry Scully, credit director for Hayward, Calif.-based Mervyn's, "As the bank card industry becomes more aggressive" with inducements, "we need to be more aggressive" with the store card strategy.

In fact, Scully says, "I don't necessarily disagree" with Bjorndahl's philosophy on offering private label card incentives.

One inducement that Mervyn's recently instituted is a "15% coupon" offering with the acquisition of a Mervyn's card, explains Scully. The coupon entitles a customer to a 15% discount on items purchased during a single transaction.

According to Scully, the California apparel retailer has seen an increase in Mervyn's store card sales, compared to last year. He boasts that the coupon inducement is a "big piece" of the increase.

But Denny Kerr, director of marketing for Dallas-based J. C. Penney Credit Services, does not buy Bjorndahl's point that private label cards should offer incentives. Bank cards need to offer incentives as an inducement because all the cards have the same purchasing power, he says.

Private label cards, however, present a distinct "affinity" between the merchant and consumer, says Kerr. The store card offering is intended for consumers interested in what the card's mailings provide in store merchandise and sales.

"That, however, is the conventional view of the private label card with its customer," argues Bjorndahl. "The study results tend to refute that view," he adds, "as more cards fight for shelf space in the wallet."

But Kerr says, "I know we are not losing on the private label side," in terms of the number of cards issued and their active use the first half of this year, compared to the same time period last year.

According to Jack McCarley, vp-public affairs for Los Angeles-based Bullock's, the concept of offering incentives with private label cards is "interesting." The concept is the type of thing that would make a difference at point-of-sale, he says. In fact, "It's something that should be looked at," adds McCarley, and "if it seems feasible, we will."

But in his opinion, right now the customer would prefer more lenient credit terms, such as deferred credit and 90-day free credit on major purchases.

Currently, California is working on deregulating its credit market and close to passing such legislation, notes McCarley. "Then we can use credit as a merchandising tool, rather than be hamstrung by official rate limits," he says.

If California is a leading market indicator, as Bjorndahl claims, retailers and credit card vendors need to keep on the pulse of consumer's "plastic money" appetite.

If retailers are to begin rethinking their store cards, says Bjorndahl, perhaps they should also follow on the heels of bank cards and begin serving up incentive packages. ■

CONSUMERS RATE DEBIT CARDS 'MOST IMPORTANT'

The bank card piquing the most curiosity from retailers is not Visa or MasterCard, but the Automated Teller Machine (ATM) card, according to The West Coast Group study of California credit card use.

In the last five years, the study says, the ATM card (or debit card) is the one most widely held among consumers. Seventy percent of the study's respondents have one, and half of them say it is their single most important card.

Maybe now is the time that more retailers accept the ATM card at point-of-sale, says Greg Bjorndahl, partner at The West Coast Group, Irvine, Calif. In California at least, there already are a number of programs where retailers are marketing this offer cooperatively with banks (*Chain Store Age Executive*, May 1988).

Leading retailers are grocery chains, followed by convenience chains, gasoline chains and department stores, observes Bjorndahl. Department stores are last because of reduced number of visits by consumers, compared to other retail categories.

According to J. C. Penney Credit Services marketing director Denny Kerr, "More retailers are looking at the idea" of accepting the ATM card at point-of-sale. Though J. C. Penney is "keeping abreast" of it, the company is not actively pursuing the idea.

Kerr says that department stores are slower to move with the ATM cards because they already have several payment options established. Grocery chains, however, have not accepted credit cards, so are eager to establish some type of payment option like ATM.